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Business in Brief

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THE CHASE MANHATTAN BANK

10 Pine Street, New York 15, N. Y.

Industrial production has been virtually level this year, with declines in steel and autos largely offset by increases in other industries. Nevertheless, this stability in over-all production has given rise to a growing mood of caution on the part of consumers and businessmen.

For perspective, it should be remembered that a production plateau characterized the final stages of the two previous business cycles. In both cases the plateau extended almost 2 years (August 1950 to August 1952, and December 1955 to August 1957). The current period of leveling, which was interrupted by the steel strike, is a bit more than a year old.

In the 1949-1953 cycle the plateau was followed by a boom in late 1952 and early 1953. Steel and auto output soared after the 1952 steel strike. In contrast, the period of level production from December 1955 to August 1957 was followed by the downturn into the 1957-58 recession.

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This historical analogy raises two questions about the immediate future. Will the economy work out of a period of rolling adjustment into one of renewed advance? Or is the current plateau a prelude to another business cycle downturn?

In considering the question, look first at the trends which produced the stability in over-all industrial activity.

¶ **Inventory buying** has see-sawed from a rate of $11.5 billion in the second quarter of 1959, to a small reduction in the third quarter, then up to $11.4 billion in the first quarter of this year, and down again to a minus figure in July. Over-all, inventories are about as high in relation to sales as before the two previous business cycle downturns.

¶ **Plant and equipment expenditures** are up 11% in the past year – not a vigorous recovery by past standards. The recent SEC-Commerce survey shows that business plans to hold expenditures level for the remainder of the year.

¶ **Housing starts** continued to decline from May through July, despite some increase in the availability of mortgage credit. Nationwide reports show that demand for new housing is not as strong as in earlier periods. However, a further easing in credit, plus efforts by builders to meet demand, could lead to some increase in the period ahead.

¶ **Government expenditures** have been level for more than a year as a decline at the Federal level has offset increased spending by state and local governments. However, Federal expenditures are now on the rise. Thus, total government purchases of goods and services could increase $5-6 billion in the year ahead.

¶ **Retail sales** declined 3% from April to August, largely because of a slowing in auto sales. Surveys show that consumers are increasingly hesitant in buying durable goods. However, consumer income is running 5% ahead of a year earlier, so total expenditures for goods and services have continued to increase.

This review of key economic trends reveals an economy operating at a high level and absorbing rather severe adjustments in individual areas. In the near future some pick-up in steel output, which dropped one-third between March and August, appears possible. Production has run below consumption for some months, and inventories are at low ebb. Auto production will also rise, perhaps a bit more than seasonally, as stocks of the 1961 models are built up. With stability or small increases in other industries, the index of industrial production could remain relatively steady in the near future.

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However, the current picture is not one of an economy girding itself for a vigorous advance. Only two major sectors – government and consumption of nondurables and services – appear to show expanding trends that could extend into next year. Such key areas as business investment in new plant and equipment, inventories, housing and durable consumers goods exhibit at best stability.

The major area of uncertainty is new plant and equipment. Profits have been disappointing this year, a development that usually leads to reductions in budgets for capital expenditures. However, such expenditures have not been unduly high this year or last, so that any necessary adjustment may prove moderate.

In fact, the strength of the economy during the past year in face of difficult adjustment problems is reassuring. A free economy requires periods of adjustment to pave the way for a period of rapid growth. The hope is that any further adjustments that may lie ahead can be absorbed with a minimum of over-all disruption and that they will lay the foundation for a new period of growth.

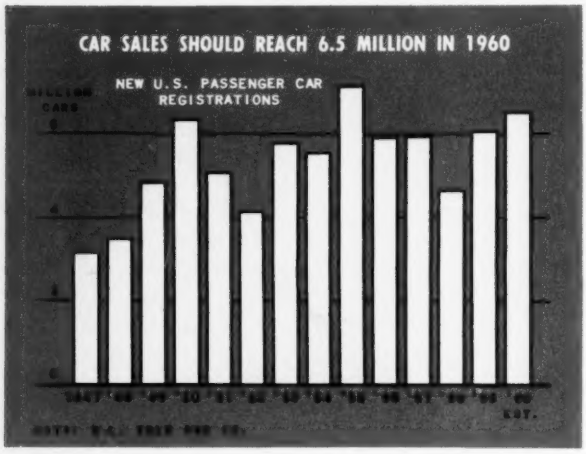
THE 1960 AUTOMOBILE YEAR

The 1960 model year was a notable one for the automobile industry. Over six million U.S. cars were turned out – the best year since 1955 when a record 7.1 million cars were produced. Compact cars accounted for over one-fourth of domestic output. And imports declined, reversing a five year uptrend.

These shifts in the auto market are obviously important to business as a whole. For one thing, auto sales are among the most volatile factors in the economy, so an appraisal of sales prospects is basic to an evaluation of the business outlook. At the same time, the increasing emphasis on compact cars has repercussions throughout the economy.

The Shift Towards Compact Cars

The shift to compact cars has been dramatic. Three years ago sales of domestic compact cars plus imports (which consist mostly of smaller cars) ran to 300,000 units, less than 5% of the total market. In the 1960 model



year, almost 1.6 million domestic compact cars were produced and imports ran to an estimated 600,000. Thus, smaller cars made up one-third of the total.

What is more, the trend appears to be picking up momentum. Compacts have accounted for almost 28% of registration since March, compared to about 22% in the early part of the 1960 model year. And four new compacts will be introduced by U.S. manufacturers in the 1961 model year. In addition, the trend in standard cars is towards a reduction in length, breadth, and width.

The change in the pattern of auto sales follows a long period during which the trend had been towards a steady upgrading in the size, complexity and performance of cars. From 1935 to 1959 the average expenditure per new U.S. car in constant dollars rose about 1½% a year, and in the more recent period, from 1953 to 1959, by almost 3% a year. This reflected not only increased size and horsepower, but also the wider acceptance of automatic transmission, power steering, power brakes and the like.

As a result, the average factory retail price in constant 1960 dollars per new car sold climbed from about $2200 in 1953 to $2600 in 1959. The length of a typical "big three" car increased from almost 16½ feet in 1953 to nearly 18 feet in 1959, and the weight rose by about 500 pounds.

In contrast, the compacts are some 2½ feet shorter and some 1200 pounds lighter than the larger 1959 cars. In size and weight they are more nearly comparable to the standard big three models of the late 1930's. Yet they incorporate many design changes for improved performance as well as such optional conveniences as automatic transmissions, and in some compact cars, power steering and power brakes.

Effect of Compacts on Other Cars

What effect has the introduction of the new compact cars had on the automobile market?

- Standard-size, low-priced cars have been affected the most. Their share of production plus imports fell from 56% in 1959 to 44% in 1960.

- The share of more expensive cars dropped from 28% to 24%. But that was well below the 1950-1955 average of 43%.

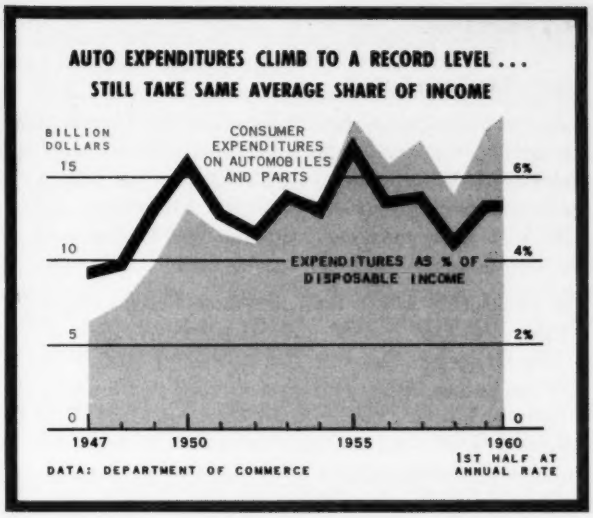
- Imports fell from 10% to an estimated 9% of the total market. And second quarter 1960 sales were 17% below second quarter 1959 sales. Imports not only turned down. For the first time since 1955, domestic compacts' share of the market exceeded the imports' share. This may be a significant point in domestic producers' competitive battle with the imports. Just two years ago, the imports outsold the compacts two to one. The imports most affected in 1960 have been those produced abroad by U.S. companies.

- Used-car prices have been running about 7% or more below year ago prices, in part because of competition from the compacts. Such competition could also mean higher rates of scrappage of older cars if compacts tend to take the place of used cars.

Effect on Supplying Industries

The compacts may have an important effect not only on the automobile industry itself but on suppliers and the economy in general. It has been estimated that a typical compact takes about 25% less steel, uses less gasoline per mile, and will cost about $40 less annually for repairs than a standard-size low-priced model. Less will be spent for insurance, and tax revenues will be lower. On the other hand, compact cars may use more of such materials as aluminum. And because they are less expensive to operate, compact car owners may step up the use of their cars and partly offset the effect of compacts on gasoline and oil use.

While there are likely to be significant shifts among



supplying industries, there is, as yet, no evidence that the compacts will reduce the over-all importance of the automobile industry in the national economy. Expenditures on autos as a percent of consumer income was as high in 1959 and the first half of 1960 as the average for the past decade. In addition, the continuation of successful competition with imports could help maintain the place of domestic cars in the economy.

The Current Situation

Even though longer term trends could be favorable, there remains the problem of year to year volatility in auto sales. During the past decade auto sales have not moved in the same direction for more than two years in a row.

On the favorable side, it would appear that 1960 has not been marked by some of the excesses that characterized 1950 and 1955. Consumer expenditures on autos and parts have been in line with their average relationship to income – in 1950 and 1955 spending on autos was notably above past ratios. In addition, auto credit outstanding rose 14% in 1955 as against 11% in the past year.

At the same time, there appear to be a number of uncertainties in the picture:

- In July and August car sales lagged behind year-ago levels for the first time this year.

- The large block of 1960 models remaining to be sold could affect sales of the new models. On September 10th stocks in dealers' hands were 834,000 – an estimated 200,000 above average stocks on that date during the previous five years.

- Surveys show that consumers are becoming increasingly cautious about making commitments to purchase autos and other durable goods.

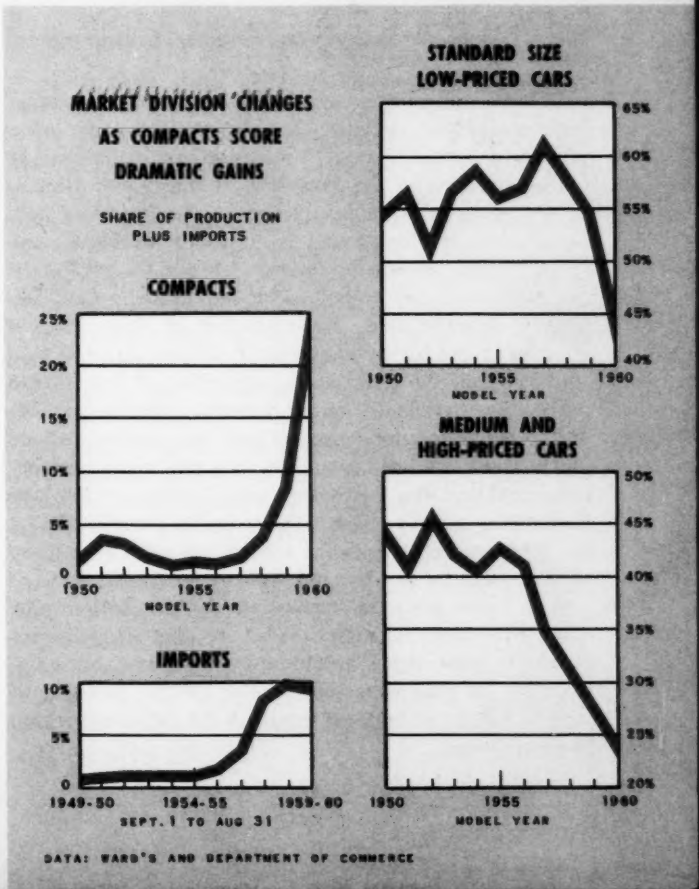
- Consumer incomes have been growing at a slower rate in recent months. The growth in automobile credit, now at a record 5% of consumer income, has slackened.

However, longer term factors would appear to favor general growth in automobile sales in the years ahead. With the number of cars eight years old or older on the increase, the rate of scrappage is rising. At present, more than 4 million cars are scrapped each year. This basic replacement market could grow by one-third in the next five years.

The growth in family formation in prospect – a rise from 900,000 a year now to almost 1.2 million in the second half of the decade – favors increased car sales. About 75% of all families now own cars (up from 50% in 1947), and this might go up to 85% in the years ahead.

Another dynamic factor is the growth in households owning two or more cars. At present 20% of families owning cars fall in this category. As family incomes rise, this proportion could increase – industry estimates are that 25-33% is an attainable figure by 1965. In the past few years, the growth in multiple car ownership has been responsible for sales of some 600,000 cars a year.

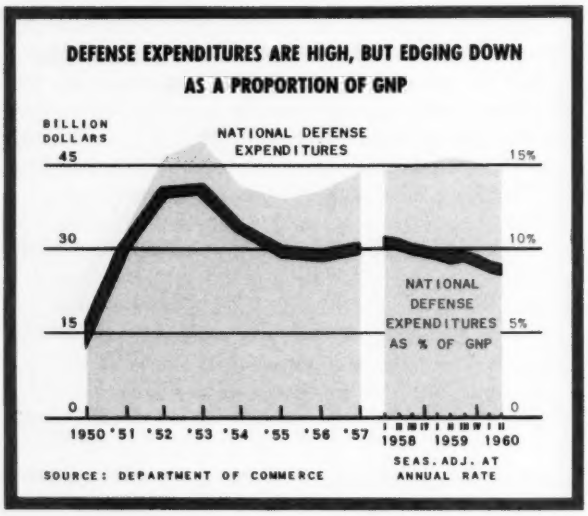
When these factors are added together, it would appear that over the longer run the outlook for automobile sales is promising. The auto buyer will be offered a wider range of choice than has been the case in recent years. And the compacts may actually broaden the auto market by complimenting larger models and fitting into the changing pattern of consumer needs for personal transportation.



DEFENSE SPENDING

Defense spending is scheduled to move up in the months ahead. However, present prospects are that the rise will be moderate and that it will not represent a sharp break with recent patterns of spending. Two factors point to an increase:

First, total national security expenditures (which comprise Defense Department outlays, military assistance, atomic energy, and stock-piling) began the current fiscal year at an annual rate that was a full billion dollars below the $45.6 billion requested for fiscal 1961 in the President's Budget message.



Second, appropriations voted by Congress for military functions of the Defense Department (the major component of national security) were $662 million above the level requested by the President. While appropriations do not necessarily have to be spent, the President indicated in August that a part of the funds would be used. In particular, this means increased funds for the Polaris and B-70 programs as well as for the Strategic Air Command's airborne alert, modernization of Army combat equipment and for development of military airlift.

Changes in the trend and composition of the defense program can vitally affect our position in the world. Decisions made now influence not only our present posture vis-à-vis the Soviet Union, but our defense capability two, three and four years from now. Military technology is changing rapidly. The problem is also complicated by the long lead-time between embarking on the building of new weapons systems and their operational use.

Both major party platforms state that the nation must make the effort necessary to insure that our defense capability makes both limited and general aggression untenable. To gain some perspective on the problem, it may be helpful to examine trends in the defense program in recent years.

What Has Been Spent

In the seven years since the end of the Korean War, the nation has spent $308 billion on national security. Since mid-1957, spending has held quite steady, with outlays fluctuating between $44 and $46 billion. What role do defense outlays of this magnitude play in our economy?

- In relation to the total economy, defense expenditures averaged 10% of gross national product in the 1954-60 period. Since the first quarter of 1958, stability in the annual dollar outlays combined with expanding national output have reduced the ratio from 10.3% to 8.8% of GNP.

- Since the end of the Korean War, national defense expenditures have averaged 62% of total Federal Budget expenditures (Department of Defense outlays alone have taken up 55%). The 1961 Budget calls for national defense as a whole to take up 57% of Budget expenditures (and the Department of Defense, 51%).

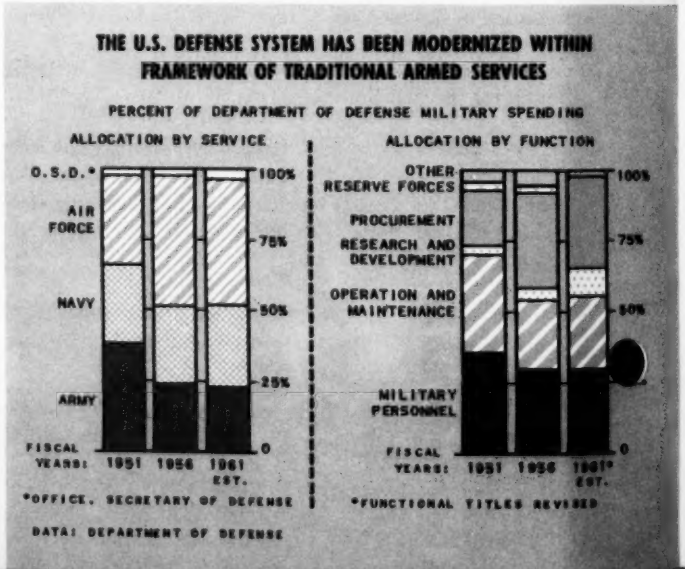
Defense spending, then, has changed little in recent years and constitutes a slightly smaller burden on our economy. But, the unit costs of defense are rising (and rising faster than other costs in the economy), indicating that outlays in real terms have been declining.

- Expenditures for military personnel, for example, are slightly higher than in 1955, but the number of active forces has been reduced by 450,000, indicating about a 20% increase in personnel costs per man.

- Similarly, the cost of each flying hour has risen 11% in the last two years, and each steaming hour is up 15%.

Changes In Our Defense System

However, the post-Korean period has witnessed dramatic changes in the military effectiveness of our defense system. The major technological advance involves the shift from conventional arms to nuclear weapons, from



manned aircraft to guided missiles. The emphasis in our defense effort has shifted to the design of retaliatory systems against surprise attack.

The strides towards development of new weapons systems have been taken essentially within the framework of the traditional armed services and with little change in the division of funds among the major functional categories (personnel, operation and maintenance, and procurement). However, this relative structural stability masks the drastic shifts that have occurred in our weapons systems. Thus, there have been significant changes in the allocation of funds for research and development and procurement.

The Role of Research and Development

Research and development has been of primary importance in spearheading the technological strides in our defense system. Expanding from less than $760 million at the beginning of the Korean War, spending on research, development, test and evaluation will be close to $4 billion in fiscal 1961 – or almost 10% of Defense Department military expenditures.

Expenditures have risen so rapidly in part because of the complexity and speed of technological change. To design new weapons and warning systems and to bring them to the stage where they are operational requires extensive research, development, test and evaluation.

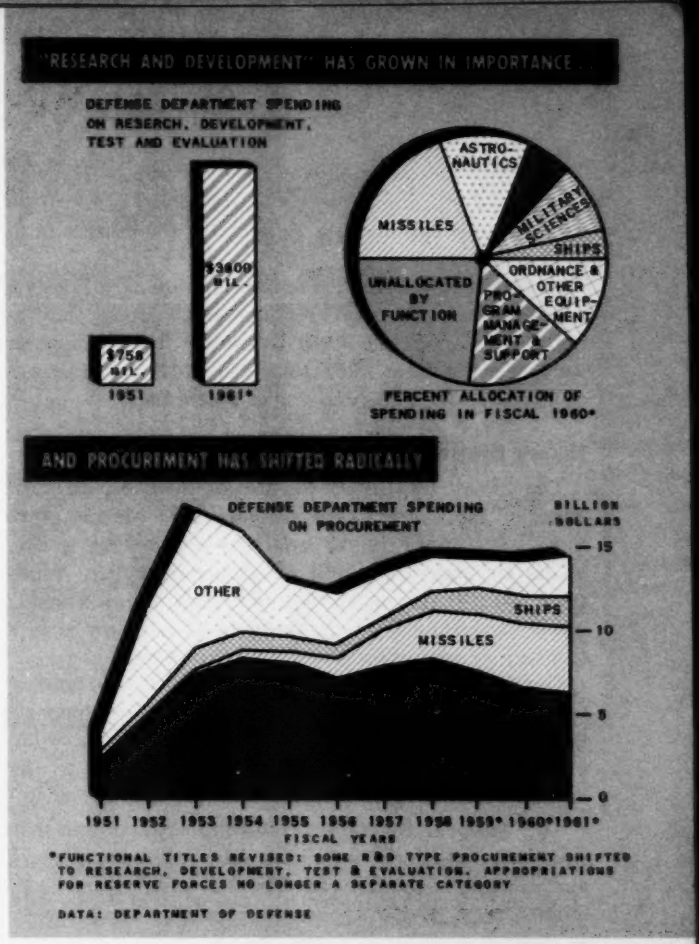
Shifting Patterns of Procurement

The breadth of the changeover in weapons systems is illustrated by the sharp shifts in procurement.

- In 1955, 62% of procurement funds went into aircraft; in fiscal 1960, with outlays of $6.7 billion, the proportion was down to 47%.
- On the other side, outlays for missiles shot up 450% in five years – from $700 million to almost $4 billion with the share of procurement rising from 5½% to 27%.
- Finally, outlays for ships (including nuclear powered submarines, carriers and other vessels) increased absolutely and as a proportion of spending, while expenditures for ground equipment declined.

These shifts in spending, however, do not necessarily present irreversible trends. Spending on ground equipment is now rising in an effort to modernize Army combat equipment. Outlays in fiscal 1960 approached $600 million – the first increase in the post-Korean period. If Army combat equipment is to be modernized completely, considerably larger outlays would be involved. (During the Korean War, ordnance, vehicles and related equipment required annual outlays of $3.5-$5 billion.)

There are signs, too, that the missile program may have reached a stage where further expansion may be slowing down – outlays for fiscal '61 may not change much from last year's level. At the same time, re-evaluation of our air defense has led to speculation that we may have cut back on manned aircraft too greatly, with the result that there has been pressure to speed up the development of the supersonic B-70 bomber. And, recent successes in the firing of Polaris missiles from submarines have called for a step-up in the submarine program.



Faced with a Soviet challenge that shows little sign of abating and with continuous scientific progress on both sides, it seems certain that our defense effort must be responsive to ever-changing developments if our capabilities are to be maintained and, if need be, strengthened. Thus, there would appear to be little prospect of an easing of the burden of national security expenditures.

At the same time, it is important to note that we have carried through a considerable re-orientation in the defense effort and maintained a most impressive military potential by devoting about 10% of our national product to national security. This is substantially below the 13½% ratio reached during the Korean War. Meantime, national output measured in constant dollars is one-fourth higher than it was during the 1950-1952 period.

Consequently, if a further increase in defense expenditures should be called for to maintain the nation's security and position of leadership in the free world, the record shows that the U.S. economy could shoulder a greater burden than is now being carried. To do so, however, the nation would have to accept a higher tax burden, or submit to the less-apparent, though still real, tax imposed by inflation.

BUSINESS CYCLE INDICATORS

How can we evaluate the current position of the economy? Is there any evidence that business activity has reached or is approaching its peak for the current business cycle?

In searching for answers to these questions, it is useful to study the business cycle indicators chosen by the National Bureau of Economic Research. These 21 series were selected from more than 800 statistical measures on the basis of their behavior in past cycles.

Theory Behind The Indicators

The theory underlying the use of these indicators is based on the nature of the business cycle. At any given time, some industries or activities are moving ahead, others are stable, and still others are declining. When those which are expanding outweigh those showing stable or declining trends, the general economy is in a recovery or expansion phase; and vice versa.

During an expansion, the ground is laid for the ensuing contraction. The rate of advance in business tapers off as more activities show stable or declining trends. This, in turn, exerts downward pressure on other activities and the economy as a whole.

The National Bureau's 21 indicators are designed to summarize and interpret the complex interactions which make up the business cycle. They are divided into three groups: eight *leading* indicators, which typically turn up or down before turns in general activity; eight *roughly coincident* indicators which track with the over-all economy; and five *laggers* which usually follow the parade.

A review of the record of the leading indicators since 1946 shows both their advantages and disadvantages as a business forecasting device.

- The line measuring the leaders has turned down in advance of each recession, up before every recovery.
- On the other hand, there have been occasions when the leaders gave false signals (1951, for example).
- Another problem arises because of the varying time-lag between a turn in the leading indicators and a turn in general business. In the postwar period, downturns in the leaders preceded the decline in general business by a period varying from 22 to 31 months.

For these reasons, a signal given by the leaders needs to be confirmed by trends in the coincident indicators before one can be sure that a change in the direction of business activity is in the making (or underway). Typically, weakness in the leading indicators appears a year or so before the coincident indicators begin to lose strength. At times, however, the leaders have turned up again after a year or so of weakness, and this has been followed by an improvement in the coincident indicators, and in business, which lasted for some time.

The Present Status of the Indicators

Against this general background, consider the present status of the indicators. They first began to display weakness in the spring of 1959. While the steel strike was a disturbing influence, it is clear that a number of the individual leading series reached peaks from which they have been declining or which they have not regained.

In April 1959 new incorporations reached their high point, followed in May by peaks in average hours per week and commodity prices, in June by durable goods orders, in July by construction contracts, and at the end of the year by stock prices and liabilities of business failures.

However, the coincident indicators have not, as yet, turned down, though they have begun to show certain weakening tendencies. Thus, the business cycle indicator approach, while suggesting caution in appraising business prospects, has not yet signaled a downward turning point in general business activity.

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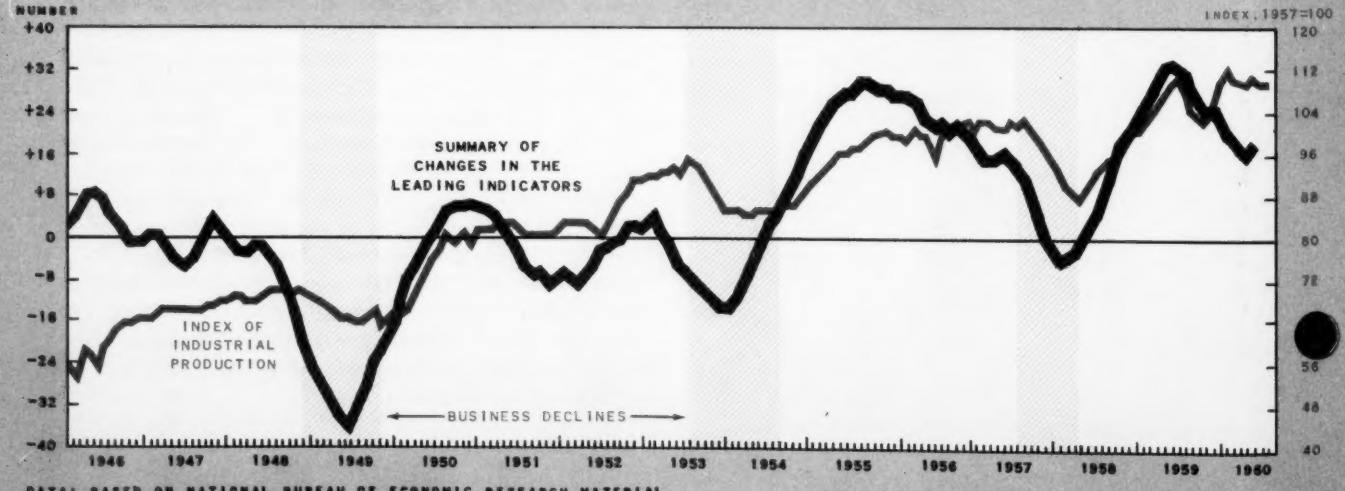

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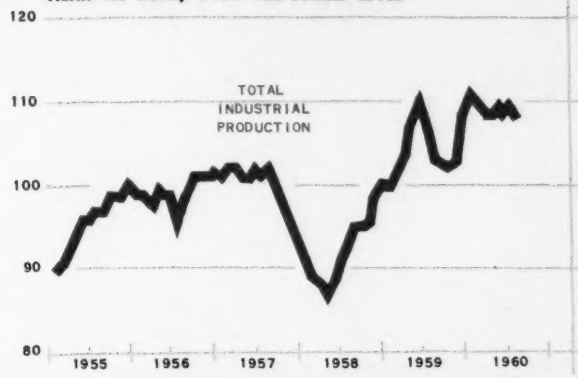

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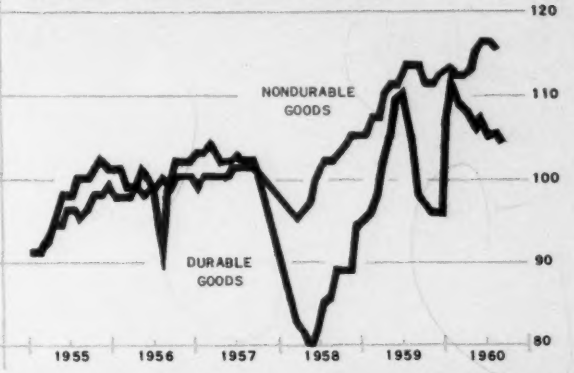

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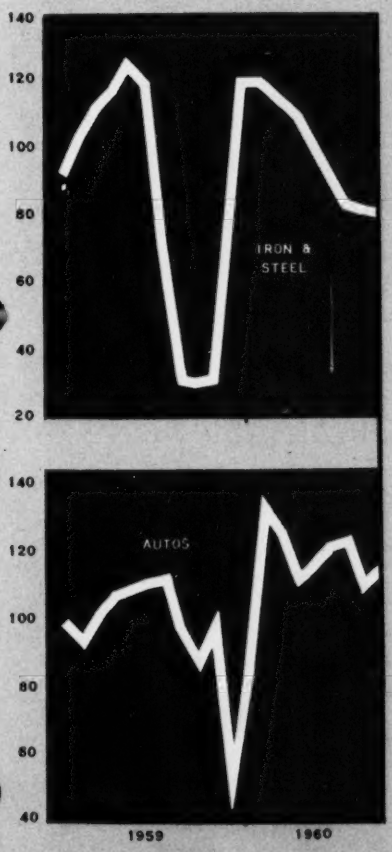

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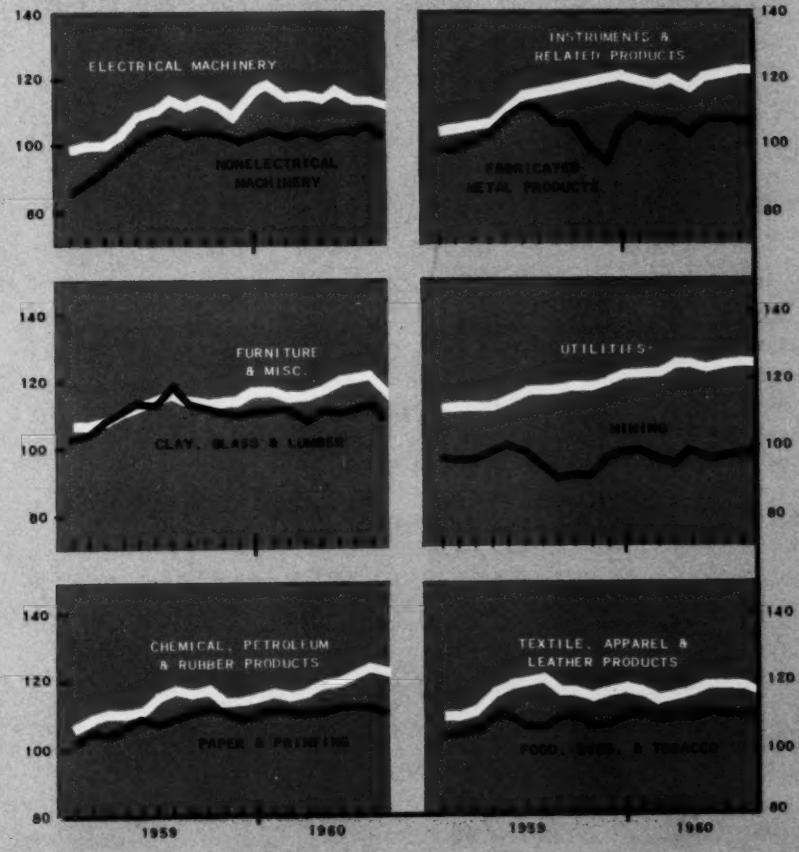

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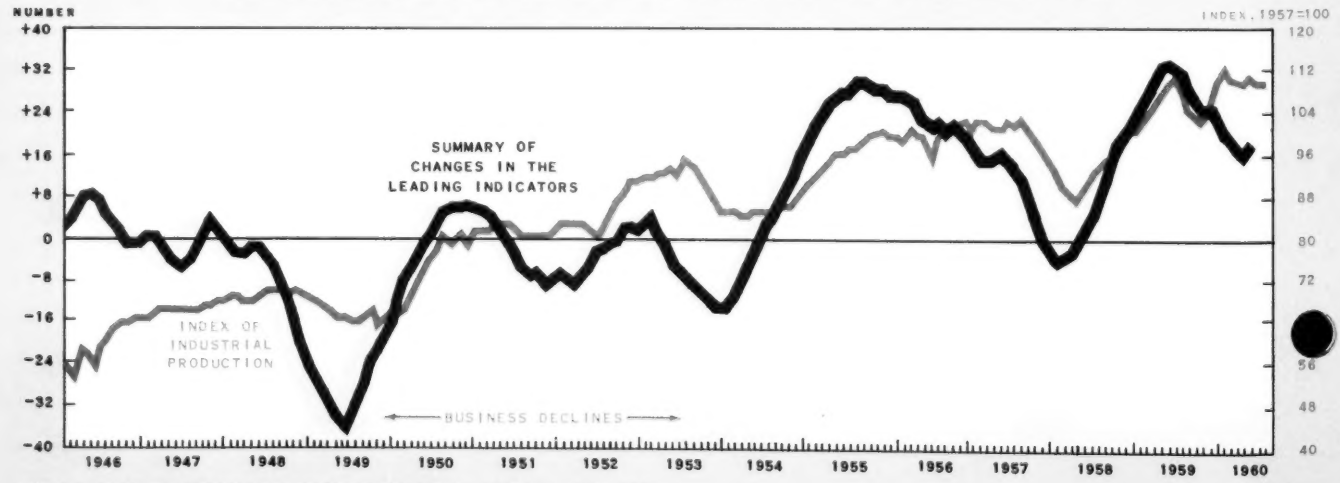

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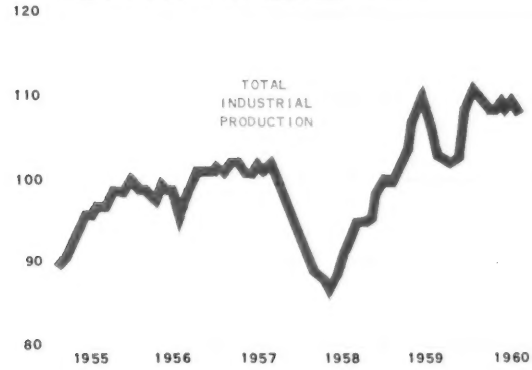

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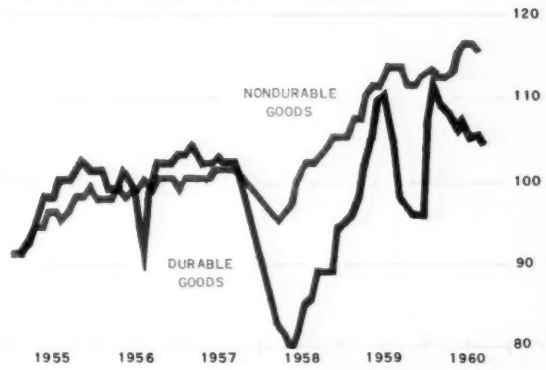
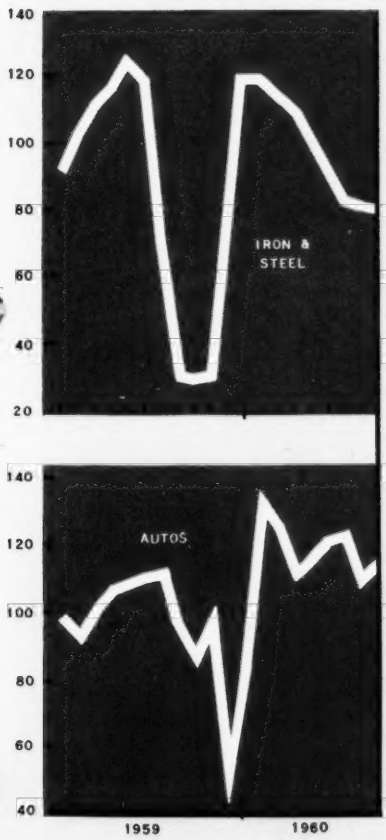
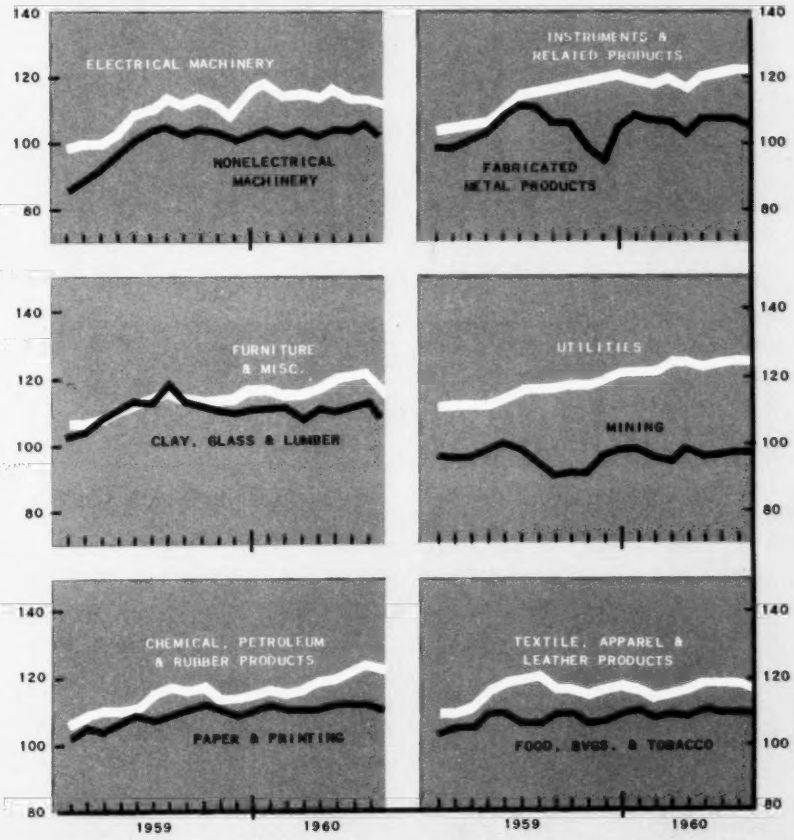


RECENT DECLINES IN OUTPUT OF STEEL AND AUTOS . . .



HAVE BEEN OFFSET BY STABLE OR RISING PRODUCTION IN MOST OTHER INDUSTRIES



DATA: FEDERAL RESERVE BOARD.

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On the pole or at the switchboard, telephone people everywhere have common cause.

It's service, sweetened always with plain, old-fashioned courtesy.

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